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FEDERAL COMMUNICATIONS COMMISSION  
OFFICE OF SECRETARY

July 15, 1996

Honorable Reed E. Hundt, Chairman  
Federal Communications Commission  
1919 M Street, NW  
Washington, D.C. 20544

Re: *Ex Parte* in Federal-State Joint Board on Universal Service, CC Docket No. 96-45.

Dear Chairman Hundt:

On June 11, 1996, Mr. Frank J. Gumper of NYNEX wrote to you raising several concerns about the Hatfield Model estimate of Total Service Long Run Incremental Cost ("TSLRIC"). These concerns are based both on a misinterpretation of the model's methodology, as well as an unwillingness to accept the implications of the Telecommunications Act for NYNEX's current monopoly rates. I hope that this brief response clarifies some of the issues he raises.

NYNEX criticizes the Hatfield Model as producing results that would be "confiscatory" if they were used for setting rates. It is not clear from this criticism whether any measure of economic costs that falls short of its existing revenue requirement would be acceptable to NYNEX for setting the rates of unbundled network elements, or whether NYNEX wants the Commission to embrace embedded cost pricing as the proper pricing standard under the Act. In any event, NYNEX's disapproval of the Hatfield Model is surprising in light of its use of incremental cost studies at many points in the past to justify low rates for competitive services. For example, NYNEX has advocated use of incremental cost studies to support rates for Centrex services and for intral ATA toll services.<sup>1</sup> At the same time it was using

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<sup>1</sup> See, for example, New York Telephone Performance Regulation Plan, Section IV H4, Approved in Case 92-C-0665, June 1, 1995.



embedded cost studies to "demonstrate" the level of "contribution" needed to preserve its revenue requirement.

In the past, it was not appropriate for telephone companies to design cost studies to suit particular purposes, yet this practice persisted. With passage of the 1996 Act, the days when telephone companies could mix and match cost studies to suit their advocacy concerns are over. With the opening of all telecommunications to competitive entry, all services should be priced efficiently. The new legislation calls for an economic cost standard, and TSLRIC is the standard that best meets the statutory requirement.

NYNEX's first substantive criticism is that "the Hatfield Model does not represent TSLRIC":

The Hatfield Model is not based on real costs -- it is a "blank slate" model of a hypothetical LEC network that might be constructed from scratch using the lowest-cost technology available today.

NYNEX is attempting to redefine TSLRIC to suit its own purposes. TSLRIC is supposed to be based on a blank slate. The relevant costs are those that an entrant utilizing efficient technology would incur. This is precisely the kind of network MCI intends and expects to deploy. Existing ILEC networks include overcapacity and inefficiencies. The NYNEX version of TSLRIC would result in an asymmetry in the market: only ILECs would be able to recover uneconomic costs in their rates.

The second major criticism is that "the Hatfield Model grossly underestimates network investment levels." The first part of this criticism is apparently that NYNEX believes that the Hatfield Model constructs a "bare bones" network. As noted in the NYNEX's letter, the Model has been fully documented in filings in CC Docket No. 96-98. That documentation shows that the Model includes all of the investment and expenses needed to provide the facilities and services for which cost estimates are provided. Indeed, the loop investment costs utilized in the Hatfield Model builds on the Benchmark Cost Model of which NYNEX was a co-sponsor. The Hatfield Model does not include services or facilities that are not part of universal service requirements or necessary to provide the unbundled network elements competitors require. Nor should it. For example, broadband capabilities needed to allow NYNEX to compete with cable companies in video market are not included in the Hatfield Model. Also, contrary to the assertion in the letter at footnote 1, the Hatfield Model is in the hands of the Commission and is available to the public.

NYNEX argues that "... the interexchange carriers want the ability to purchase interconnection and unbundled network elements from the LECs because they do not believe that they could build a new local network at the same cost as the existing LEC

network." This is a gross simplification of the complicated dynamics associated with introducing competition to the local exchange. In any event, the point of the unbundling requirements of the new Act is precisely to allow competitors to purchase network elements more efficiently provided by ILECs.

The second part of the criticism is that NYNEX believes that the Hatfield Model does not contain "sufficient capacity to handle peak demand and growth." In fact, the model is engineered to handle peak loads and assumes reasonable fill levels -- that is, fill levels sufficient to allow for network growth. For example, the fill levels for distribution cables range between .50 and .75 depending on density. The Hatfield Model does not contain capacity for video, interLATA long distance and competitive Centrex service, nor should it.

NYNEX's third major criticism is that "The Hatfield Model 'disallows' major portions of the LECs' current expenses." Expense levels are fully justified in the documentation of the Model referred to earlier. MCI believes that the existing interstate allowed rate of return is excessive and has shown that elsewhere.<sup>2</sup> MCI finds it ironic that ILECs are using the threat of competition as justification for maintaining rates of return at their current excessive levels, or even increasing those rates. One would expect competition to force rates down from current monopoly levels. The Hatfield Model overhead factor is generous. Contrary to NYNEX's assertion, Customer Operations expenses are included in the basic universal service rates estimated by the Hatfield Model. These costs are appropriately excluded from the cost of interconnection and unbundled network elements. Finally, the Hatfield modelers have consistently requested ILECs to provide forward-looking operational cost studies to substitute for the factors used in the current model. That ILECs have failed to provide these studies is the best evidence that the Hatfield results are conservatively high.

The assertion that using engineering-economic cost models to estimate local telephone company costs is the equivalent of a rate case is absurd. Quite the contrary, the alternative to economic cost modeling is to rely on embedded costs. This would require a mammoth rate case to discover the appropriate cost to charge competing firms.

The fourth major criticism advanced by NYNEX is that "the net effect of the Hatfield Model is confiscatory." NYNEX arrives at this conclusion by misinterpreting the estimates provided by the Model. The correct interpretation of the results is that if the ILECs were to immediately lose all of their end user customers to competitors

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<sup>2</sup> See "Statement of Matthew I. Kahal Concerning Cost of Capital," In the Matter of Rate of Return Prescription for Local Exchange Carriers, File No. AAD95-172, March 11, 1996.

purchasing interconnection and unbundled network elements, they would collect 44 percent of their existing revenue requirement. This hypothetical situation will not happen. It will take time for competition to develop. The ILECs will be able to recover prudent retailing costs not included in the TSLRIC of interconnection and unbundled network elements. In addition, ILECs will enjoy new revenue generating opportunities as a result of passage of the 1996 Act. In sum, economic costing of interconnection and unbundled network elements will not place the ILECs at financial risk.

The final point of criticism advanced by NYNEX is that "joint and common costs must be added to TSLRIC pricing to produce 'economic' rates." The so-called joint and common cost problem is not really a problem at all. Shared costs among subsets of unbundled network elements are insignificant and can be recovered by a pro rata allocation based on underlying investment. After inclusion of an economic variable overhead factor, which is contained in the Hatfield Model, the only common costs not included in the Model's TSLRIC estimates are for a small portion of corporate overhead. The cost of these overhead functions is quite small. MCI believes that all firms should recover such costs from end user customers. NYNEX and other ILECs seek to recover these costs from their competitors, who will then be forced to recover both their own common costs and those of their ILEC competitors from end users. In any event, if the Commission were to decide to allow ILECs to recover some portion of these costs in rates for interconnection and unbundled network elements and for Basic Universal Service, we believe that pro rata assignment of the costs over all ILEC services would yield a marginal increase (less than one percent) above the Hatfield costs.

I look forward to answering any questions you or your staff may have concerning the Hatfield Model.

Sincerely,

A handwritten signature in black ink, appearing to read "Michael D. Pelcovits". The signature is fluid and cursive, with a stylized "M" and "P".

Michael D. Pelcovits  
Chief Economist